# DEPARTMENT OF HOMELAND SECURITY Office of Inspector General

## Independent Auditor's Report On TSA's FY 2004 Financial Statements



Office of Audits

**OIG-05-40** 

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U.S. Department of Homeland Security Washington, DC 20528



#### Preface

The Department of Homeland Security (DHS) Office of Inspector General (OIG) was established by the Homeland Security Act of 2002 (Public **Law** 107-296) by amendment to the Inspector General Act of 1978. This is one of a series of audit, inspection, and special reports published by our office as part of our DHS oversight responsibility to promote economy, effectiveness, and efficiency within the department.

This report presents the results of the audit of the Transportation Security Administration's (TSA) financial statements as of September 30, 2004, and for the year then ended. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audit. The contract required that KPMG perform its audit according to generally accepted government auditing standards and guidance from the Office of Management and Budget and the Government Accountability Office. KPMG issued an unqualified opinion on TSA's financial statements for fiscal year 2004. KPMG's report identified two material weaknesses related to information technology and internal control monitoring, and an additional reportable condition related to grants management. KPMG is responsible for the attached auditor's report dated November 5,2004, and the conclusions expressed in the report. We do not express opinions on TSA's financial statements or internal control or conclusions on compliance with laws and regulations.

The recommendations herein have been discussed in draft with those responsible for implementation. It is our hope that this report will result in more effective, efficient, and economical operations. We express our appreciation to all of those who contributed to the preparation of this report.

Richard L. Skinner Inspector General

Russed L. Skinner

Financial Statements and Management's Discussion and Analysis September 30,2004

(With Independent Auditors' Report Thereon)

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KPMG LLP 2001 M Street, NW Washington, DC 20036

### **Independent Auditors' Report**

To the Assistant Secretary for Department of Homeland Security, Transportation Security Administration, and Inspector General, Department of Homeland Security:

We have audited the accompanying consolidated balance sheets of the U. S. Department of Homeland Security's (DHS) Transportation Security Administration (TSA) as of September 30, 2004 and 2003, and the related consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing, for the year ended September 30, 2004. The objective of our audits was to express an opinion on the fair presentation of these financial statements. In connection with our audits, we also considered TSA's internal control over financial reporting and tested TSA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on its financial statements.

#### **SUMMARY**

As stated in our opinion on the financial statements, we concluded that TSA's consolidated balance sheets as of September 30, 2004 and 2003 and the related consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing, for the year ended September 30, 2004, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

- Information Technology
- Internal Control Monitoring and Evaluation
- Grants Management

We consider the Information Technology and Internal Control Monitoring and Evaluation reportable conditions, above, to be material weaknesses.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. TSA was not subject to the requirements of the *Chief Financial Officers Act of 1990* (CFO Act) during fiscal year 2004 and, consequently, was not required to comply with the *Federal Financial Management Improvement Act* (FFMIA). Therefore, we are not reporting herein on TSA's compliance with FFMIA. However, our testwork disclosed deficiencies in financial management information systems (i.e., OMB Circulars A-127, *Financial Management Systems*, and A-130, *Management of Federal Information Resources*) related to FFMIA, which are presented in Exhibit I.



The following sections discuss our opinion on TSA's financial statements, our consideration of TSA's internal control over financial reporting, our tests of TSA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements, and management's and our responsibilities.

#### OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of the Department of Homeland Security's Transportation Security Administration as of September 30, 2004 and 2003, and the related consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2004. In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of TSA as of September 30, 2004 and 2003, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the year ended September 30, 2004, in conformity with accounting principles generally accepted in the United States of America.

The information in the Management Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

#### INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect TSA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2004 audit, we noted certain matters, described in Exhibits I and II, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that the reportable conditions presented in Exhibit I are material weaknesses. Exhibit II presents the other reportable condition. We noted that the TSA did not report the Internal Control Monitoring and Evaluation material weakness identified by us, described in Exhibit I, in its FMFIA year-end assurance statement.

A summary of the status of fiscal year 2003 reportable conditions is included as Exhibit III.

We also noted other matters involving internal control over financial reporting and its operation that we will report in the DHS Consolidated management letter.

#### **COMPLIANCE AND OTHER MATTERS**

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in FFMIA, disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02. Those instances are described in Exhibit I under Material



Weakness No. 1, Information Technology, and Material Weakness No. 2, Internal Control Monitoring and Evaluation.

TSA was not subject to the requirements of the *Chief Financial Officers Act of 1990* (CFO Act) during fiscal year 2004 and, consequently, was not required to comply with FFMIA. Therefore, we are not reporting herein on TSA's compliance with FFMIA. However, our testwork disclosed deficiencies in financial management information systems (i.e., OMB Circulars A-127, *Financial Management Systems*, and A-130, *Management of Federal Information Resources*) related to FFMIA that are presented in Exhibit Lunder Material Weakness No. 1

#### RESPONSIBILITIES

### **Management's Responsibilities**

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparing the Management Discussion and Analysis (including the performance measures), Required Supplementary Stewardship Information, and Required Supplementary Information; and
- Complying with laws, regulations, contracts, and grant agreements.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

### **Auditors' Responsibilities**

Our responsibility is to express an opinion on the fiscal year 2004 and 2003 financial statements of TSA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

### An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2004 audit, we considered TSA's internal control over financial reporting by obtaining an understanding of TSA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating



objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982* (FMFIA). The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered TSA's internal control over Required Supplementary Stewardship Information by obtaining an understanding of TSA's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02 with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis section, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether TSA's fiscal year 2004 financial statements are free of material misstatement, we performed tests of TSA's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to TSA. We also note that while OMB Bulletin No. 01-02 requires certain testing and reporting on the compliance requirements of FFMIA, TSA was not subject to those requirements during fiscal year 2004, and as a result, testing for compliance with FFMIA requirements was not an objective of our engagement. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

#### **DISTRIBUTION**

This report is intended for the information and use of TSA's management, DHS's Office of Inspector General, OMB, the Government Accountability Office (GAO), and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.



November 5, 2004, except as to notes 10 and 13, which are as of December 21,2004

Discussed below are reportable conditions that we believe are material weaknesses:

### 1. Information Technology

Information technology (IT) controls related to TSA's primary financial applications owned and operated by the Department of Transportation (DOT) need to be improved, including DOT's financial accounting system (i.e., Oracle Federal Financial Management Implementation known as DELPHI); the Integrated Personnel and Payroll System (IPPS); and the Consolidated Uniform Payroll System (CUPS). The TSA uses DOT's core accounting system, DELPHI, to process and record financial transactions.

Specifically, we noted weaknesses in IT security management for the DELPHI system in the following areas: access controls, segregation of duties and controls related to the financial system's data integrity. Access control and segregation of duties weaknesses included excessive privileged access to the DELPHI operating system, excessive numbers of users with the ability to override financial transactions, and lack of management review of DELPHI audit trail reports for sensitive transactions. Additionally, DELPHI technical support staff at DOT had considerable access to financial management operational functions within the TSA environment. These weaknesses increased the risks related to the integrity of DELPHI operations and financial transaction processing.

We identified several systems integrity issues impacting the integrity of TSA financial management and reporting data. This included, for example, posting errors of accounts receivable receipts to the general ledger and the ability to alter banking information on validated unpaid invoices. In light of these issues with the DELPHI system, TSA has established compensatory measures that include weekly meetings with the DOT DELPHI technical support management team, as well as reconciliation and manual controls to detect and correct problems and to ensure that past problems are not recurring.

We also noted that the DELPHI system is not a fully integrated system with respect to its general ledger. Further, the TSA's property management system was not fully integrated with DELPHI and relied on several manual processes to track and report fixed assets.

In FY 2004, TSA began correcting data for thousands of personnel records that were erroneously entered into TSA's personnel system (managed and operated by DOT). For example, erroneous information pertained to salary, start dates, and pension annuity calculation related data. Because of these issues, TSA began a major reconciliation initiative in April 2004, scheduled for completion by December 2004. Additionally, TSA reported that its payroll and human resources processes are moving to the National Finance Center (NFC), administered by the Department of Agriculture, by September 2005. TSA recognizes that the erroneous personnel information needs to be corrected before the migration takes place.

The above deficiencies represent instances of noncompliance with the following criteria:

OMB Circular A-130, *Management of Federal Information Resources*<sup>l</sup>, states that "agencies shall implement and maintain a program to assure that adequate security is provided for all agency information collected, processed, transmitted, stored, or disseminated in general support systems and major applications." OMB Circular A-130 emphasizes the importance of technical and operational controls in preventing and detecting inappropriate or unauthorized activities. These controls include appropriate

<sup>&</sup>lt;sup>1</sup> OMB issued OMB Circular A-130 pursuant to several legal authorities, including the Computer Security Act of 1987 and the Clinger-Cohen Act (also known as the Information Technology Management Reform Act of 1996.)

system access controls based on least privilege principles (i.e., restricting a user's access to the minimum necessary to perform his or her job) and adequate segregation of duties.

OMB Circular No. A-127, Financial Management Systems<sup>2</sup>, states that "systems must be in place to process and record financial events effectively and efficiently, and to provide complete, timely, reliable and consistent information for decision makers and the public.... These systems shall provide complete, reliable, consistent, timely and useful financial management information on Federal government operations to enable central management agencies, individual operating agencies, divisions, bureaus, and other subunits to carry out their fiduciary responsibilities; deter fraud, waste, and abuse of Federal government resources; and facilitate efficient and effective delivery of programs...." Further, financial management systems, including other systems that support financial systems, should be integrated, meaning that they "provide for effective and efficient interrelationships between software, hardware, personnel, procedures, controls and data...."

OMB Circular A-123, Management Accountability and *Control*<sup>3</sup>, states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other related reports." Additionally, "key duties and responsibilities in authorizing, processing, recording, and reviewing official agency transactions should be separated among individuals. Managers should exercise appropriate oversight to ensure individuals do not exceed or abuse their assigned authorities."

#### Recommendations:

TSA will be migrating to another version of the Oracle Federal Financial Management System, owned and operated by the Coast Guard, in fiscal year 2005. TSA should coordinate with the Coast Guard to ensure the effectiveness of Coast Guard's IT controls and operations, particularly as they relate to appropriate access controls, segregation of duties and data integrity. KPMG also agrees with TSA that reconciliation and manual controls, currently established to ensure accuracy and completeness of accounting and financial reporting information, should continue until assurance is available that Coast Guard's IT controls affecting TSA's financial reporting are effective and adequate.

KPMG recommends that TSA continue reconciliation efforts to correct all erroneous personnel records in the TSA personnel system (managed and operated by DOT). TSA should ensure that adequate resources are available to complete the project, so that no major data integrity issues exist prior to migrating to the NFC system.

### Management's Response:

TSA has reviewed the material weakness related to information technology controls and agrees with KPMG's recommendations. Regarding access controls and segregation of duties, TSA will initiate actions described in the recommendations after the accounting data has been successfully transferred to the Coast Guard accounting system from DELPHI, which is expected to occur by the end of November 2004. TSA also concurs with the DELPHI system data integrity issues and will continue their reconciliation and manual controls until assurance is available that the system controls are working correctly. Moreover, the TSA Office of Human Resources has been actively involved in ensuring that corrections to personnel records are occurring as planned and that controls will be established to prevent recurrence of this issue.

<sup>&</sup>lt;sup>2</sup> OMB issued OMB Circular A-127 pursuant to FMFIA and the CFO Act. Although TSA was not subject to the CFO Act during FY 2004, it was subject to FMFIA and to this Circular.

<sup>&</sup>lt;sup>3</sup> OMB issued OMB Circular A-123 pursuant to FMFIA.

### 2. Internal Control Monitoring and Evaluation

Currently TSA identifies control weaknesses by reviewing status reports provided by the financial statement auditors, GAO reports, and Office of Inspector General reports. However, this process is not sufficient to comply with FMFIA, under OMB Circular A-123, which requires management to have primary responsibility for monitoring and assessing controls. According to a senior financial specialist, TSA is working to develop a Management/Internal Control Program. KPMG also noted that TSA did not report the Internal Control Monitoring and Evaluation material weakness in its FY 2004 FMFIA year-end assurance statement.

OMB Circular A-123 states: "Management has primary responsibility for assessing and monitoring controls, and should use other sources as a supplement to—not a replacement for—its own judgment."

#### Recommendation:

We recommend that TSA implement a process to monitor and evaluate its accounting and internal controls, thereby improving the overall control structure, and also to meet the requirements for FMFIA reporting.

#### Management's Response:

TSA concurs with the recommendations regarding compliance with FMFIA. TSA reported that on November 9, 2004, the Assistant Secretary approved implementation of a comprehensive Internal Management Control Program. Under this program, all TSA assessable units will be required to implement local controls, document those controls, conduct periodic self-assessments, and submit an annual report on the effectiveness of controls to the next highest level of management. This process will be in place to support the preparation of TSA's fiscal year 2005 FMFIA Statement of Assurance.

### 3. Grants Management

TSA entered into a significant number of grant agreements during fiscal year 2004. Although the technical management of most of these grants and the issuance of new grants for a majority of the grant programs was transferred to the Office of State and Local Government Coordination and Preparedness (SLGCP, formerly the Office of Domestic Preparedness) in the third quarter of fiscal year 2004, TSA retains the administrative responsibilities for the grants it awarded in fiscal year 2004 until closeout. We noted several deficiencies in the grants management process:

- Seven of the fifty grants tested did not have performance reports on file.
- Four of the grant agreements tested did not have an SF-424 (application package) in the grant award files. According to grants management personnel, the application packages could not be accessed after being entered into the Port Security Grant system.
- Six of the sample items tested had SF-270s (Request for Advance or Reimbursement) that were not signed or authorized by the grants or program officer. When the forms are submitted online, the grants officer sends an email approving the invoice to the finance officer. These sample items were not supported by a signature on the SF-270 or the email approval was not available.
- TSA does not have policies or procedures in place to properly monitor grantee compliance with OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

OMB Circular No. A-110, Uniform Administrative Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations, Section 51, states that "Recipients are responsible for managing and monitoring each project, program, subaward, function, or activity supported by the award... The Federal awarding agency shall prescribe the frequency with which the performance reports shall be submitted.... Performance reports shall not be required more frequently than quarterly or, less frequently than annually."

Additionally, each award document, which is signed by the grantee agency and the grants officer, includes stipulations regarding how often and what type of performance documentation is required to be submitted by the grantee.

The GAO Standards for Internal Control in the Federal Government, GAO/AIMD-00-21.3.1 (November 1999), states:

- "Internal controls and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. All documentation and records should be properly managed and maintained."
- "Control activities occur at all levels and functions of the entity. They include a wide range of diverse activities, such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, and the creation and maintenance of related records, which provide evidence of execution of these activities as well as appropriate documentation. Control activities may be applied in a computerized information system environment or through manual processes."

#### Recommendations:

#### We recommend that TSA:

- Implement policies and procedures to ensure that performance reports for grants and agreements are received in accordance with grant award documents and OMB requirements;
- Implement document retention policies and procedures that include obtaining physical copies of document approvals, placing them in award files, and maintaining application packages in grant files; and
- Implement policies and procedures to ensure that grantees are monitored for compliance with OMB Circular A-133.

### Management's Response:

Except for the research and development grants issued by the Transportation Security Laboratory, TSA concurs with this finding and recommendation on Grants Management. DHS Management Directive No. 0773, *Grant Management Responsibilities and Functions*, is currently out for comment, but the TSA will comply with the directive once it is signed and effective. As such, the Office of Acquisitions will immediately develop and implement a process to coordinate with SLGCP to ensure application packages are maintained, performance reports are obtained, and OMB Circular A-133 requirements are being complied with and monitored.

| Fiscal Year 2003 Findings   | Current Year Test Results |
|---|---------------------------|
| TSA does not have a comprehensive automated property management system in place that interfaces and reconciles with the general ledger. In addition, TSA Office of Property Management is inadequately staffed to support property movement and associated property accountability requirements.  | Corrected                 |
| TSA does not have adequate processes in place to accurately record accounts payable accruals and adequately track information about leasing arrangements for disclosure in the financial statements.  | Corrected                 |
| Access Control: Some of the technical staff had excessive access to production data and program and operating system level access, such as user account maintenance, special privileges, and monitoring access.   | Repeat Condition          |
| Limited Capabilities: TSA faces risk associated with the continued use of outdated technology related to the Consolidated Personnel Management Information System (CPMIS) because of the lack of available training and limited number of individuals with the skill and ability required to maintain system capabilities and support data management requirements. | Corrected                 |
| Personnel Security: Improvements are needed in processing separated employees from TSA on a timely basis. Separated employees were carried in the personnel system after their effective separation date. In addition, many records in the CPMIS contain erroneous information.   | Repeat Condition          |
| Certification and Accreditation Activities: DELPHI operations are susceptible to unauthorized or inappropriate access and inappropriate modifications to the system. Additionally, continuity of operation is not assured in the event of a service disruption.   | Corrected                 |
| Intragovernmental Activity: TSA does not have a formal documented process in place to reconcile and confirm all intragovernmental activity on a quarterly basis. TSA has not developed and has not been provided guidance related to documented procedures for quarterly reconciliations with its trading partners.   | Corrected                 |
| Records Retention Management: TSA personnel files requested for testing were either missing or did not contain all the applicable forms (i.e., health and life benefit election forms). Furthermore, requested accounts payable, expense, property, and undelivered orders supporting documentation were not readily available.                                     | Corrected                 |
| TSA does not have a process in place to monitor and evaluate its internal controls in order to meet the reporting requirements for the Federal Managers' Financial Integrity Act (FMFIA) reporting. FMFIA requires an evaluation to be completed by December 31 of each year.   | Repeat Condition          |

Management's Discussion and Analysis September 30,2004

#### Introduction

The United States Department of Homeland Security's (DHS) Transportation Security Administration (TSA), presents to the American public, Congress, the Office of Management and Budget (OMB) and the transportation industry the current performance of TSA's major programs and a brief description of how the public benefits from them. Additionally, the financial statements describe our recent accomplishments and financial initiatives and position for fiscal year 2004.

The major developments in our program and financial activities and the progress and commitment we have made to meet our strategic goals are described in the following sections of this report.

Management's Discussion and Analysis, consists of the following three sections:

- Overview of TSA provides a high level overview of the administration. It provides a description of who we are, what we do, and how well we meet the goals we have set.
  - *Major Program Performance* activities are designed to ensure that America's transportation security meets the needs of the American people as we progress into the 21<sup>st</sup> Century.
- Financial Management Performance highlights TSA's progress with auditable financial statements; accrual accounting; the Federal Managers' Financial Integrity Act; property, plant and equipment; and cash management.

*Financial Statements and Notes*, provide an important tool to promote and improve accountability and stewardship over the public resources entrusted to the administration. Statement preparation provides accurate and reliable information used in assessing performance and allocating resources.

Audit Report indicates whether:

• The financial statements fairly present the financial position and results of TSA operations in accordance with OMB Bulletin 01-09 and the generally accepted accounting principles applicable to the United States Government.

The management's discussion and analysis and required supplemental information sections are materially consistent with the financial statement information.

Required Supplemental Information and the Required Supplemental Stewardship Information, relates to areas of Federal Government accountability over certain resources entrusted to TSA and certain responsibilities assumed by TSA, which are not measured in traditional financial reports. This information focuses on assets and investments made by the government for the benefit of the Nation.

Readers who would like to know more about TSA's programs and organization may access the TSA Internet Web Site at http://www.tsa.gov.

### Overview of the Transportation Security Administration

On November 19, 2001, the President signed into law the Aviation and Transportation Security Act (ATSA), which established TSA as an operating administration within the U.S. Department of Transportation. Effective

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March 1, 2003, TSA was transferred to the newly created Department of Homeland Security and is currently a component organization within the Border and Transportation Security Directorate (BTS) of the U.S. Department of Homeland Security (DHS). TSA was given the mission to develop and implement transportation security policies and programs that contribute to providing secure transportation for the American public, which is essential to meeting the national objectives of security, economic growth and stability, and the efficient use and conservation of resources.

Under the leadership of its assistant secretary, TSA is guided by several key principles. The first principle is leadership – leading people, leading the development and deployment of technology to maximize resources, and leading change. The second principle is partnership. TSA has worked to develop and promote a spirit of partnership with all stakeholders involved in protecting, operating, and using the Nation's transportation systems. Lastly, critical to TSA's success is its ability to inspire the trust and confidence of the American people and their elected representatives in the Congress.

TSA, BTS and DHS as a whole, and other Federal and private transportation stakeholders have been working collaboratively to provide seamless transportation security. Ensuring that the Nation's transportation systems are secure can only be accomplished through effective partnering between Federal, state, local, and private industry entities.

### **Strategic Planning**

The TSA Strategic Plan defines the goals and objectives that must be fulfilled to successfully achieve the Agency's mission, and plays an integral role in performance-based budgeting and management efforts.

More specifically, TSA must identify, understand and anticipate the domain in which it operates, and lake action to deter foreign and domestic terrorists and other individuals from causing harm or disrupting the transportation system and/or its users. In the event that a terrorist attack does occur, the Agency must coordinate an agile incident response to swiftly and effectively restore freedom of movement. Ultimately, the Agency must operate as a leading edge, performance-based organization that consistently meets its performance objectives while practicing outstanding stewardship of its resources. As such, our four goals are defined as follows:

Domain Awareness – Ensure we gain awareness of the full scope of activities in our domain of responsibility.

*Prevent/Protect* – Deter foreign and domestic terrorists and other individuals from causing harm or disrupting the transportation system and/or its users.

Respond/Restore - Ensure that an agile incident response capability is coordinated to swiftly and effectively restore freedom of movement.

Organizational Effectiveness – Operate as a leading edge, performance-based organization that consistently meets performance objectives while practicing outstanding stewardship of our resources.

Additionally, TSA has identified the following performance goals and performance measures that link directly to the overarching strategic goals as defined in the Agency's Strategic Plan:

Performance Goal- Work with DHS components in partnership to fully deploy a comprehensive threat-based security management system for use in all modes of transportation, and ensure zero successful

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attacks against the transportation system as a result of the mishandling or misinterpretation of intelligence infosmation received by TSA Intelligence Service.

• *Performance Measure* – Number of successful attacks resulting from mishandling or misinterpretation of intelligence information received by TSA intelligence service.

*Performance Goal* – Ensure the safe, secure, and efficient transport of passengers and property via air transportation.

• Performance Measure – Passenger Screening Program Index.

*Performance Goal* – Develop and prepare for the deployment of technologically advanced systems to identify and eliminate illegally transported explosive devices, chemical, biological, radiological, nuclear and other weapons.

• Performance Measure - Baggage Screening Program Index.

*Performance Goal* – Operate as a performance-based organization that implements the President's Management Agenda (PMA) for improved effectiveness and efficiency.

• *Performance Measure* – Use departmental scorecards to measure success in the following areas: Strategic Management of Human Capital, Competitive Sourcing, Improved Financial Performance, Expanded Electronic Government, and Budget and Performance Integration.

*Performance Goal* – Develop and deploy technologically advanced systems for screening air cargo to ensure the safe and secure transport of passengers and property via air transportation.

Performance Measure – Percent of known shipper cargo inspected on passenger aircraft.

*Performance Goal* – Protect the Nation's transportation system by deterring, detecting, and defeating 100% of attempted hostile acts through the effective deployment of Federal law enforcement and inspections personnel.

• *Performance Measure* – Percent of qualified airports that have executed law enforcement reimbursement agreements.

### **Major Program Performance**

In December 2003, Homeland Security Presidential Directive 7 (HSPD-7) assigned DHS the responsibility to "coordinate protection activities" for the Transportation Sector, which consists of six discrete modes: aviation, maritime, mass transit, highway, pipeline and rail. DHS, in turn, assigned Transportation Sector Specific Responsibility (SSR) to TSA and tasked the Agency with the development of a Sector-Specific Plan (SSP) for the Transportation Sector.

While the TSA Strategic Plan can be used as an internal roadmap, the SSP has a much broader scope and specifically encompasses each facet of transportation security. The SSP provides a detailed description of the specific processes that will be used to identify, assess, prioritize, protect, and measure effectiveness throughout the Transportation Sector. In developing this plan, TSA worked with numerous public and private organizations to collect infosmation on projects, initiatives, activities, timeframes, milestones, resource requirements, and the

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status of current security efforts, as well as any identified best practices, challenges encountered, and products generated. This information will better enable DHS to identify, prioritize and protect critical infrastructure and key resources, and will directly impact the Agency's current and future security efforts.

Since the creation and stand up of TSA nearly three years ago, and with the establishment of BTS and DHS, we have advocated layered security and designed our security programs around the concept of a "system of systems." A sample of these efforts is discussed in greater detail in the sections below.

**Aviation Security** – Prior to 9/11, there were fewer than 100 names on the "no-fly" list. Today, TSA provides carriers with "no-fly" and "selectee" lists that have been dramatically expanded. New names are being added every day as intelligence and law enforcement agencies submit new names for consideration. In addition, we have reduced the number of passengers whose names are erroneously matched to the "no-fly" list. Continued expansion will be possible as integration and consolidation of various watchlists by the Terrorist Screening Center (TSC) progress and as the U.S. Government is able to assume the responsibility for conducting list comparisons.

Over the past year, TSA continued to implement protective measures to secure the aviation mode, while overseeing ongoing security operations at airports nationwide. The Federal Flight Deck Officer (FFDO) program, for example, trains and arms aviators to protect an aircraft's cockpit, thereby providing an effective deterrent against a possible terrorist attack against passenger and cargo aircraft. The FFDO training curriculum continues to be modified, where necessary, to conform to the operating environment of cargo aircraft. For example, TSA modified and added new judgment pistol simulator scenarios to reflect the cargo aircraft environment. TSA also evaluated the defensive tactics and firearms training portions of the existing FFDO training course.

Another initiative, the Registered Traveler (RT) Pilot Program, is designed to improve the security screening process by helping TSA align Screeners and resources with potential risks. Registered travelers will be positively identified at the airport through biometric technology. Passengers who have volunteered for this program will go through expedited security screening at specially designated lanes. Approved registered travelers will be directed to a designated checkpoint lane where they will provide their biometrics (fingerprint and iris scan) and, in some locations, a Registered Traveler Smart Card containing biometric information for identity confirmation. Registered travelers and their carry-on bags will still go through primary screening, but more extensive secondary screening will be largely eliminated, unless they alarm the Walk Thru Metal Detector. The RT program is being piloted at Minneapolis-St. Paul International Airport, Los Angeles International Airport, George Bush Intercontinental Airport (Houston), Boston Logan International Airport, and Ronald Reagan Washington National Airport.

TSA's Threat Image Protection (TIP) program, which regularly tests Screener performance at identifying prohibited items, is now in full time use at all Screener lanes at all airports. Additionally, TSA has replaced the previous TIP image library of 200 images with an expanded library of 2400 images, and has established interim national performance standards to assist in TIP data analyses as well.

In partnership with the Department of State, TSA leads U.S. efforts to strengthen aviation security at the global level by promoting the adoption of best practices within international organizations that set the pace and standards for aviation security. TSA works with the Department of State to support the implementation of existing standards and the adoption of new, stronger standards via international organizations, such as the Group of Eight (G-8), the International Civil Aviation Organization (ICAO), and the European Union. TSA and State

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actively pursue the alignment of U.S. and foreign aviation security requirements through bilateral agreements and security representation at U.S. embassies and consulates.

**Intelligence** – One of TSA's most important strategic goals is the expansion of domain awareness throughout the transportation sector to enhance the industry's prevention and response capabilities. As part of the Agency's ongoing threat analysis, Assistant Secretary Stone and other TSA senior leaders conduct comprehensive reviews each morning of the intelligence assembled in all sectors of transportation and the threats that may be implied by this intelligence. Additionally, this group reviews and discusses in detail daily reports from Federal Security Directors (FSDs) around the country on incidents in aviation security, and holds a weekly intennodal stakeholder teleconference to share unclassified intelligence, provide information on TSA security programs and solicit input.

Additionally, TSA analysts vetted the entire population (approximately 2.7 million) of HAZMAT credentialed truck drivers against intelligence and immigration databases to identify potential security threats. A total of 68 referrals were made to the Federal Bureau of Investigation based on potential terrorist links; and another six were referred to Immigration and Customs Enforcement for immigration related investigation.

Maritime and Land Security – The Transportation Worker Identification Credential (TWIC) program is testing alternatives for developing and potentially implementing a secure credential that could be used to mitigate possible threats posed by workers with fraudulent identification in transportation industries. The TWIC program is intended to enhance security controls applicable to the variety of transportation personnel whose duties require unescorted access to secure areas. TSA recently began the prototype phase, which uses biometrics to verify identity and prevent duplicate enrollments. TWIC will verify identities by comparing the cardholder's finger(s) with the fingerprint template stored securely on the card's integrated circuit chip. The TWIC prototype and supporting measures will test how best to assess the risks of transportation workers entering secure areas.

Additionally, TSA worked with AMTRAK to implement the Transit/Rail Inspection Pilot (TRIP) program, which tests the feasibility of screening luggage and carry-on bags for explosives at manned rail stations, unmanned rail stations, and on board trains. Phase I of the pilot was conducted at the New Carrollton, MD station, which serves multiple types of rail operations. Phase II was launched in June 2004, a program for explosives screening of checked baggage and parcels at Union Station in Washington, DC. Phase III was launched in July 2004 for explosives screening of passengers and carry-on baggage inside a mobile train car fitted with security technologies.

Lastly, TSA has participated in Operation Safe Commerce (OSC), which is a collaborative effort between the Federal government, business interests, the largest U.S. container load centers (Los Angeles/Long Beach, Seattle/Tacoma, and New York/New Jersey) and the maritime industry to develop and share best practices for the secure and expeditious movement of containerized cargo. TSA will use the results from the projects to develop container supply chain best practices and standards for use by commercial maritime shippers.

**Research and Development** – Research in biometric technologies continues to be integral to several TSA initiatives, including the RT pilot program, the TWIC program, infrastructure access control programs, and employee screening. TSA coordinates with US-VISIT and U.S. Customs and Border Protection (CBP) to leverage research and initiatives already underway. Establishing standards for sources of identification is a complex process involving efforts to ensure access identification does not reinforce an assumed identity, measures to reduce false matches, appropriate levels of performance for biometric technologies, safeguards for

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identity information, and other functionality. The research and testing now underway through existing programs are critical steps toward establishing effective standards for secure identity verification.

### **Management Achievements**

The Agency's ability to achieve its mission, fulfill its performance goals, devise effective strategies and allocate resources appropriately is enhanced by its understanding of historical trends and performance results. TSA is proud that the results of its goals were met or showed improved trends. The following are accomplishments of TSA during FY 2004 as they relate to the above-mentioned performance goals:

- Worked with DHS components in partnership to fully deploy a comprehensive threat-based security management system for use in all modes of transportation, and ensure zero successful attacks against the transportation system as a result of the mishandling or misinterpretation of intelligence information received by TSA Intelligence Service. The 9/11 Commission concluded that better interpretation, handling, and coordination of intelligence throughout the Federal and transportation community may have prevented the tragic attacks of September 11, 2001. As such, TSA's target for this goal is that there will be no hostile attacks that cause harm to the traveling public or transportation industry. Over the past year, TSA has met its objectives in support of this goal.
- Ensured the safe, secure, and efficient transport of passengers and property via air transportation. TSA is constantly improving its performance in keeping dangerous items off commercial aircraft. FY 2004 saw changes in training, hiring, and re-certifying Screeners that lead to better screener performance and professionalism. The deployment of advanced technology at the checkpoints and improved procedures contribute to more effective and efficient screening. Additionally, new initiatives such as RT and TWIC are helping to make screening more efficient. TSA baselined the passenger screening index, a composite rating that measures effectiveness, cost, and customer satisfaction, at 3.3 out of a possible 5 points.
- Developed and prepared for the deployment of technologically advanced systems to identify and eliminate illegally transported explosives devices, chemical, biological, radiological, nuclear and other weapons. A large portion of the American taxpayers' investment in aviation security technology goes toward the development, deployment, and effective professional use of advanced equipment to screen checked baggage. To support the Baggage Screening Program Index and provide an assessment of TSA's success, the Agency uses data from automated and covert Screener testing, customer surveys, and cost modeling to determine ratings. On a scale of 1 5, with 5 the highest possible score, TSA baselined the index with a 3.2 score in FY 2004.
- Operated as a performance-based ovganization that implements the President's Management Agenda for improved effectiveness and efficiency. Each quarter, DHS receives a red, yellow, or green rating from OMB on each of the five PMA areas. In turn, DHS issues ratings to TSA based on several criteria within each PMA area. TSA translates the color-coded rating into a numerical score of 1 to 3, with 3 being the highest a "green" rating for all criteria. This numerical translation allows more sensitivity that enables TSA and the public to see in one score the general trend and success TSA is having implementing the President's management agenda. TSA achieved a performance rating of 2.3 during FY 2004.
- TSA will develop and deploy technologically advanced systems for screening air cargo to ensure the safe and secure transport of passengers and property via air transportation. TSA continues to make progress following the release of the Air Cargo Strategic Plan, and uses the measure "Percent of known shipper

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cargo inspected on passenger aircraft" to gauge its progress toward the achievement of this goal. This proxy measure focuses on the aviation industry's compliance to cargo security requirements that are designed to ensure the safe and secure transportation of air cargo. TSA has met its target of 10% for FY 2004.

• Protect the Nation's transportation system by deterring, detecting, and defeating 100% of attempted hostile acts through the effective deployment of Federal law enforcement and inspections personnel. The proxy measure for this goal is "Percent of qualified airports that have executed law enforcement reimbursement agreements," which focuses on the extent that TSA provides financial assistance to airports for the expenses of providing law enforcement support at the passenger and baggage checkpoints. This funding will help make sure the checkpoints are suitably staffed to provide effective protection from hostile acts. The measure is based on the number of funded Reimbursement Agreements (RA) signed by TSA and the airports, and tracked in the Law Enforcement Program Management database. TSA has exceeded its target of issuing RAs, initially set at 61%, by issuing 91% of the funded RAs for FY 2004.

### **Financial Management Performance Highlights**

TSA's budget authority is comprised of appropriated and fee resources. The fee resources include two broad categories – aviation security fees from airline passengers and air carriers that offset TSA's appropriations, and direct fee-based programs, such as the credentialing fees. More than half of TSA's FY 2004 and FY 2005 funding is or will be realized, from appropriations. TSA's budget for FY 2004, net of rescissions, and FY 2005 is listed below:

#### **Transportation Security Administration Budget**

(Amounts in millions)

|                                | -        | 2004    | 2005    |
|--------------------------------|----------|---------|---------|
| Appropriation, net of fees     | \$       | 2,689.9 | 3,260.4 |
| Federal sources – reimbursable |          | 23.3    | 200     |
| Offsetting fee collections     |          | 1,888.1 | 1,823.0 |
| FY 2005 program fees           | <u>N</u> |         | 286.7   |
| Total                          | \$       | 4,601.3 | 5,370.1 |

Most of TSA's funding is devoted to achieving overall security in the Nation's airports. Other funding is devoted to transportation security for other transportation modes.

TSA continues to implement a comprehensive aviation security program by continuing efforts to improve security at airport screening locations and speed the flow of passengers at these checkpoints. The budget for FY 2005 provides \$3.3 billion in net appropriations with an estimated \$2.1 billion of fee collections from passenger and air carrier fees and from program fees.

### **Budget and Performance Management**

The Office of Budget and Performance Management oversees the overall budget formulation, presentation, and execution activities for TSA. Specific accomplishments in FY 2004 can be summarized as follows:

17 (Continued)

2004

2005

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### Met Funding Needs

- Prepared Deparlment of Homeland Security (DHS), (OMB), and Congressional budget justification documents.
- Provided justification and analysis to DHS, OMB and Congressional support for TSA resources requests.
- Educated DHS, OMB, and Congress on TSA requirements.
- Developed TSA budget plans and implementing an agency funds allocation process.

### Improved Accountability/Responsibility

- Developed and provided analysis of program spending versus funds availability.
- Developed and refined staffing cost models to more accurately predict future staffing costs.
- Developed and delivered Budget Resource Development and Monitoring Guidelines for the Airport Administrative Officers and Financial Specialists encouraging pro-active fiscal accountability.

### Supported Customer Needs

- Supported and responded to Headquarters and field organizations on funding issues.
- Participated in working group to develop DHS future year Homeland Security Program system.
- Developed a partnership with Strategic Management and Analysis to implement budget and performance integration.
- Participated in development of TSA business plans.

### **Financial Management**

During 2004, TSA continued to build and improve its financial management operations and controls. Significant progress was made in 2004 in the areas of:

- Correcting internal control weaknesses and deficiencies identified in the FY 2003 financial statement audit, this was accomplished by reconciliation, reviewing internal reports for abnormal and unusual balances and weekly teleconferences with accounting service provider have resulted in more accurate financial data;
- Implementing various TSA-wide business practices for more streamlined and effective financial operations;
- Sponsoring the first Financial Management Training Conference for the field administrative staff
  communicating financial-related issues to both Headquarters and field staffs. This effort help the field
  administrative staff understand the importance of their work, and the need for accuracy and completeness;
  and
- Developing a balanced scorecard to ensure that TSA financial management goals and objectives are met.
   Measures were developed for selected significant financial management activities and targets were established for improved operations; and

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• Identifying, tracking, and reporting of financial management related metrics has resulted in a major reduction in TSA suspense account balances, more timely payments, a significant reduction in prompt payment interest penalty payments.

### During 2005, we plan to:

- Develop a Management/Internal Control Program scheduled for rollout in FY 2005. This is to meet the
  new requirement in the Department of Homeland Security Accountability Act for an audit opinion on
  internal controls. The program will assist leaders and managers throughout TSA establish management
  control systems.
- Improve and modernize accounting, travel, and time and attendance financial systems. A new TSA financial system is setup to "go live" on November 15, 2004. The financial data from our previous provider is being migrated to the new system and tested during October 2004 through November 2004.

#### **Revenue Management**

The Revenue Management goals, initiatives, and accomplishments during FY 2004 and plans for FY 2005 are as follows:

The primary task is to implement and collect any user fees authorized for TSA. During fiscal year 2004, TSA collected \$1.6 billion in fees from airline passengers and \$283 million from the airlines in TSA's Aviation Security Infrastructure Fees. In addition, in FY 2004, the Revenue Office drafted regulations establishing fees for two new programs: 1) background checks for alien student pilots, and 2) background checks for HAZMAT drivers. The fees for background checks for alien student pilots went into effect when the program started on October 5, 2004. The Office anticipates the fees for background checks for HAZMAT drivers to be effective by January 31, 2005. TSA is currently working on fees for TSA's TWIC, scheduled to begin during the 3rd quarter of FY 2005 as well as a potential fee for TSA's RT program.

Consolidated Balance Sheets

September 30,2004 and 2003

(Dollars in thousands)

| ASSETS  |     | 2004   | 2003  |
|---|-----|--|---|
| Intragovernmental Fund Balance with Treasury (Note 2) Accounts Receivable, Net (Note 4) Advances & Prepayments  | \$  | 2,465,921<br>1,856                                       | 2,312,796<br>130,545<br>3,636                   |
| Total Intragovernmental   |     | 2,467,777  | 2,446,977                                       |
| Accounts Receivable, Net (Note 4)<br>General Property, Plant and Equipment, Net (Note 3)<br>Advances & Prepayments                                      | _   | 150,100<br>1,330,446<br>6,404                            | 3,409<br>1,405,975<br>6,321                     |
| Total Assets  | \$_ | 3,954,727  | 3,862,682                                       |
| LIABILITIES   |     |  |   |
| Intragovernmental: Accounts Payable Other (Notes 5 & 6)   | \$  | 35,198<br>89,842   | 58,960<br>44,035                                |
| Total Intragovernmental   |     | 125,040  | 102,995   |
| Accounts Payable Advances from others Actuarial FECA Liabilities (Note 5) Accrued Payroll and Leave Accrued Unfunded Leave (Note 5) Other (Notes 5 & 6) | _   | 967,593<br>557<br>458,465<br>133,965<br>91,444<br>10,696 | 537,234<br>39,849<br>59,765<br>87,919<br>28,992 |
| Total Liabilities   | _   | 1,787,760  | 856,754   |
| NET POSITION  |     |  |   |
| Unexpended Appropriations<br>Cumulative Results of Operations   | _   | 512,558<br>1,654,409                                     | 1,137,061<br>1,868,867                          |
| <b>Total Net Position</b>   | _   | 2,166,967  | 3,005,928                                       |
| Total Liabilities and Net Position  | \$_ | 3,954,727  | 3,862,682                                       |

Consolidated Statement of Net Cost

Year ended September 30,2004

(Dollars in thousands)

| Strategic goals                                   |     | Total     | Awareness | Prevention | Protection | Response | Excellence |
|---|-----|-----------|-----------|------------|------------|----------|------------|
|   |     | 100%      | 4%        | 65%        | 27%        | 1%       | 3%         |
| Program:  |     |           |           |            |            |          |            |
| Transportation security:                          |     |           |           |            |            |          |            |
| Gross cost – intragovernmental                    | \$  | 586,823   | 23,473    | 381,435    | 158,443    | 5,868    | 17,604     |
| Less revenue earned from federal agencies         | -   | 154,769   | 6,190     | 100,601    | 41,787     | 1,548    | 4,643      |
| Net cost of services provided to federal agencies | _   | 432,054   | 17,283    | 280,834    | 116,656    | 4,320    | 12,961     |
| Gross cost – with the public                      |     | 5,550,166 | 222,006   | 3,607,611  | 1,498,544  | 55,501   | 166,504    |
| Less revenue earned from the public               | _   | 2,071,052 | 82,842    | 1,346,184  | 559,184    | 20,711   | 62,131     |
| Net cost of services provided to the public       |     | 3,479,114 | 139,164   | 2,261,427  | 939,360    | 34,790   | 104,373    |
| Net cost  | \$_ | 3,911,168 | 156,447   | 2,542,261  | 1,056,016  | 39,110   | 117,334    |

### Consolidated Statement of Changes in Net Position

Year ended September 30,2004

(Dollars in thousands)

|  | _    | Cumulative results             | Unexpended appropriations               |
|--|------|--------------------------------|---|
| Beginning balances   | \$   | 1,868,867                      | 1,137,061                               |
| Budgetary financing sources: Appropriations received Other adjustments Appropriations used Non-exchange revenues Other |      | 3,470,283<br>(4,007)<br>23,158 | 4,591,700<br>(1,745,920)<br>(3,470,283) |
| Other financing sources: Transfers-inlout without reimbursement Imputed financing from costs absorbed by others Other  | _    | (2,614)<br>209,881<br>9        |   |
| Total financing sources  |      | 3,696,710                      | (624,503)                               |
| Net cost of operations   | _    | (3,911,168)                    |   |
| Ending balances  | \$ _ | 1,654,409                      | 512,558                                 |

### Combined Statement of Budgetary Resources

Year ended September 30,2004

(Dollars in thousands)

| Budgetary resources:                                       |      |             |
|--|------|-------------|
| Budget authority: Appropriations received                  | \$   | 4,591,700   |
| Unobligated balance:                                       | Ψ    | 4,551,700   |
| Beginning of period  |      | 1,145,607   |
| Spending authority from offsetting collections:            |      | ,           |
| Earned:  |      |             |
| Collected  |      | 2,187,532   |
| Receivable from federal sources                            |      | (128,689)   |
| Change in unfilled customer orders:                        |      | 17 400      |
| Advance received   |      | 16,402      |
| Without advance from federal sources                       | _    | (116,730)   |
| Subtotal   |      | 1,958,515   |
| Recoveries of prior year obligations:                      |      |             |
| Actual   |      | 470,605     |
| Permanently not available                                  | -    | (1,722,643) |
| Total budgetary resources                                  | \$ _ | 6,443,784   |
| Status of budgetary resources:                             |      |             |
| Obligations incurred:                                      |      |             |
| Direct   | \$   | 5,867,050   |
| Reimbursable   | _    | 34,822      |
| Total obligations incurred                                 |      | 5,901,872   |
| Unobligated balances – available:                          |      |             |
| Apportioned  |      | 358,606     |
| Unobligated balances – not available                       | _    | 183,306     |
| Total status of budgetary resources                        | \$   | 6,443,784   |
| Relationship of obligations to outlays:                    |      |             |
| Obligated balance, net, beginning of period                | \$   | 1,348,883   |
|  |      |             |
| Obligated balance net – end of period: Accounts receivable |      | (1,856)     |
| Unfilled customer orders                                   |      | (93,460)    |
| Undelivered orders   |      | 914,224     |
| Accounts payable   |      | 1,103,803   |
| Subtotal   | _    | 1,922,711   |
| Outlove  |      |             |
| Outlays: Disbursements                                     |      | 5,102,858   |
| Collections  |      | (2,203,935) |
| Subtotal   | 0.70 | 2,898,923   |
| Less offsetting receipts                                   |      |             |
|  | •    | 2,898,923   |
| Net outlays  | • =  | 2,070,723   |

Consolidated Statement of Financing

Year ended September 30,2004

(Dollars in thousands)

| Resources used to finance activities: Budgetary resources obligated: Obligations incurred   | \$ | 5,901,872                     |
|---|----|-------------------------------|
| Less spending authority from offsetting collections and recoveries  | _  | (2,429,120)                   |
| Obligations net of offsetting collections and recoveries  |    | 3,472,752                     |
| Less offsetting receipts  | _  |                               |
| Net obligations   |    | 3,472,752                     |
| Other resources: Transfers-inlout without reimbursement Imputed financing for costs absorbed by others Other  | _  | (2,614)<br>209,881<br>9       |
| Net other resources used to finance activities  | _  | 207,276                       |
| Total resources used to finance activities  | _  | 3,680,028                     |
| Resources used to finance items not part of net cost of operations:  Change in budgetary resources obligated for goods, services, and benefits ordered but not yet provided  Other  |    | (2,185)<br>4,007              |
| Resources that finance acquisition of assets Other resources or adjustments to net obligated resources that do not affect net cost of operations (note 7)   | _  | 158,535<br>237,383            |
| Total resources used to finance items not part of net cost of operations  |    | 397,740                       |
| Total resources used to finance the net cost of operations  | _  | 3,282,288                     |
| Components of the net cost of operations that will not require or generate resources in the current period:  Components requiring or generating resources in future periods:  Increase in annual leave liability  Increase in exchange revenue receivable from the public  Other (note 7) | _  | 3,525<br>(146,691)<br>470,867 |
| Total components of net cost that will require or generate resources in future periods  |    | 327,701                       |
| Components not requiring or generating resources:  Depreciation and amortization Other (note 7)   | _  | 262,540<br>38,639             |
| Total components of net cost that will not require or generate resources  | _  | 301,179                       |
| Total components of net cost of operations that will not require or generate resources in the current period  | _  | 628,880                       |
| Net cost of operations  | \$ | 3,911,168                     |

Notes to Financial Statements September 30,2004

### (1) Summary of Significant Accounting Policies

These financial statements have been prepared to report the financial position, net cost of operations, changes in net position, status and availability of budgetary resources, and the reconciliation between proprietary and budgetary accounts of the Transportation Security Administration (TSA).

#### (a) Reporting Entity

TSA was created by the *Aviation and Transportation Security Act*, Public Law (PL) 107-71, (the Act), enacted on November 19, 2001, as an agency within the Department of Transportation (DOT). The Act transfewed the Civil Aviation Security functions and responsibilities of the Federal Aviation Administration (FAA) to TSA not later than 3 months after the date of enactment. TSA assumed responsibility for the Civil Aviation Security functions from the FAA on February 13, 2002. TSA's mission is to develop transportation security policies and programs that contribute to providing secure transportation for the American public. The principal statements contain financial information on all the activities of TSA. Effective March 1, 2003, TSA transferred to the newly created Department of Homeland Security (DHS), as mandated by the *Homeland Security Act of 2002*, *Public Law 107-296*. This transfer was recorded in accordance with the guidance discussed in the Federal Accounting Standards Advisory Board Technical Bulletin 2003-1.

### (b) Basis of Presentation

The financial statements have been prepared from the books and records of TSA in accordance with accounting principles generally accepted in the United States of America and the DHS accounting policies, which are summarized in this note. These statements, with the exception of the Statement of Budgetary Resources, are different from financial management reports, which are also prepared by TSA pursuant to the Office of Management and Budget (OMB) directives and are used to monitor and control TSA's use of budgetary resources.

OMB Bulletin 01-09, Form and Content of Agency Federal Financial Statements, provides guidance that requires the presentation of financial statements on a two-year comparative basis beginning with Fiscal Year (FY) 2003 reporting. TSA will present the balance sheet and notes pertaining to the balance sheet on a comparative basis. The other statements will not be presented on a comparative basis because OMB has waived the requirement for comparative statements by DHS.

Intragovesnmental activities result from activity with other Federal agencies. All other accounts result from activity with parties outside the Federal government.

#### (c) Budgets and Budgetary Accounting

TSA incurs obligations for specified purposes. TSA recognizes budgetary resources as assets when cash (funds held by Treasury) is made available through U.S. Treasury's General Fund warrants or as authorized by Congress through a Continuing Resolution.

### (d) Basis of Accounting

Transactions are recorded on an accrual basis of accounting and on a budgetary basis. Under the accrual method, revenues are recognized when earned, and expenses are recognized when incurred,

Notes to Financial Statements
September 30,2004

without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of Federal funds.

#### (e) Fund Balances with Treasury

Treasury processes cash receipts and disbursements. Fund balances with Treasury are available to pay current liabilities and finance authorized purchase obligations. TSA does not maintain cash in commercial bank accounts or foreign currency balances.

### (f) Accounts Receivable, Net of Allowances

Nonintragovernmental accounts receivable consists of amounts owed to TSA by the public. Receivables from the public arise from security fees assessed on the public and air carriers pursuant to PL 107-71. An allowance for doubtful accounts is based on specific identification and analysis of outstanding balances for reporting purposes. The allowance is adjusted accordingly at the time of collection or write-off during the fiscal year. The accounts receivable is reported net of the allowance.

Intragovernmental accounts receivable represent amounts due from other Federal agencies for reimbursement work such as investigative services. All intragovernmental receivables are considered fully collectable.

#### (g) Property and Equipment

Effective March 1, 2003, the capitalization threshold for property and equipment, with an estimated useful life of two years or more was raised to \$50,000. Prior to March 1, the capitalization threshold was \$25,000 and property and equipment was depreciated over a seven year useful life. DHS instructed TSA that capitalized property, plant and equipment prior to March 1, 2003, will continue to be recorded at the \$25,000 threshold and depreciated over a 7 year period. Property and equipment with an acquisition cost of less than \$50,000 is expensed when purchased. Software is capitalized at \$750,000.

Personal property is depreciated using the straight-line method over a useful life, determined for each general asset category, which is generally five years. Software is amortized using the straight-line method over a three-year useful life. Depreciation and amortization commences beginning with the first month after the asset is placed in service.

Progress payments made pursuant to firm contracts for the purchase of a capital asset are recorded in a capital asset account. However, the asset is not subject to depreciation until such time as the delivery of the asset takes place and the asset is placed in service.

#### (h) Advances and Prepayments

Payments made in advance of the receipt of goods and services are recorded as other assets at the time of prepayment and recognized as expenses or capitalized when the related goods and services are received.

Notes to Financial Statements September 30,2004

### (i) Liabilities

Liabilities represent the amount to be paid by TSA as a result of a transaction or event that has already occurred. However, no liability can be liquidated by TSA absent an appropriation or offsetting collection. Liabilities for which an appropriation has not yet been enacted are, therefore, classified as unfunded liabilities.

TSA awards grants and cooperative agreements to State and local governments, universities, nonprofit organizations and private sector companies to enhance and ensure the security of passenger and cargo transportation by air, land, or sea. The TSA grant liability accrual is estimated using known reported expenditures reported by grantees and the estimated daily expenditure rate for the period subsequent to the latest grantee submission in relation to the cumulative grant amount. During fiscal year 2004, the grant award functions of the TSA Maritime and Land Security programs were transferred to the DHS Secretary's new Office of State and Local Government Coordination and Preparedness (SLGCP). The transfer is to be accomplished in two phases. In the first phase, all program development and program management functions associated with the programs transitioning from TSA will be integrated with the existing Office of Domestic Preparedness program development and program management operations. The staffers associated with those functions were detailed to SLGCP, with permanent transfer at the end of FY 2004. However, the financial management functions for all grants issued prior to FY 2005 will stay with TSA.

### (j) Contingencies

TSA recognizes losses for contingent liabilities when such losses are probable, estimable, and material in amount.

### (k) Annual, Sick, and Other Leave

Annual leave is accrued as it is earned, and the accrual is reduced as leave is taken. At each bi-weekly pay period, the balance in the accrued annual leave account is adjusted to reflect the latest pay rates and unused hours of leave. To the extent that appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of nonvested leave are expensed as taken.

### (1) Benefit Plans

TSA employees who participate in the Civil Service Retirement System (CSRS) are beneficiaries of TSA's matching contribution equal to 8.51% of pay to their annuity account in the Civil Service Retirement and Disability Fund.

On January 1, 1987, the Federal Employees Retirement System (FERS) went into effect pursuant to PL 99-335. Most Federal employees hired after December 31, 1983 are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984 could elect either to join FERS and Social Security or to remain in CSRS. A primary feature of FERS is that it offers a savings plan to which TSA automatically contributes 1% of pay and matches any employee contribution up to an additional 4%. For FERS participants, TSA also contributes the employer's matching share for Social Security.

Notes to Financial Statements
September 30,2004

TSA does not report CSRS or FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management (OPM).

The majority of TSA employees are authorized to participate in the Federal Employees Health Benefits (FEHB) program and the Federal Employees' Group Life Insurance (FEGLI) program, which are administered by OPM.

### (m) Imputed Financing and Costs

TSA recognizes as imputed financing the amount of accrued pension and post retirement benefit expense for current employees. The assets and liabilities associated with such benefits are the responsibility of OPM.

#### (n) Net Position

Net position is the difference between assets and liabilities and comprises unexpended appropriations and cumulative results of operations.

Unexpended appropriations represent the amount of unobligated and unexpended budget authority. Unexpended appropriations are reduced for appropriations used and adjusted for other changes in budgetaiy resources, such as transfers and restrictions.

Cumulative results of operations represent the net results of operations since inception plus the cumulative amount of prior period adjustments. This includes the cumulative amount of donations and transfers of assets in and out without reimbursement.

#### (o) Use of Estimates

TSA has made certain estimates and assumptions relating to the reporting of assets and liabilities, the disclosure of contingent assets and liabilities and the reporting of revenue and expenses in the preparation of the financial statements. Actual results could differ from these estimates.

Notes to Financial Statements September 30,2004

### (2) Fund Balance with Treasury

Fund Balances with Treasury as of September 30, 2004 and 2003 were as follows (dollars in thousands):

|  | <u>2004</u>                                    | <u>2003</u>                                  |
|--|--|--|
| Fund Balances Appropriated Funds Other Fund Types  | \$<br>2,464,623<br>1,298                       | 2,494,490<br>(181,694)                       |
| Total  | \$<br>2,465,921                                | 2,312,796                                    |
| Status of Fund Balances with Treasury: Unobligated Balance Available Unobligated Balance Not Available Obligated Balance Not Yet Disbursed Non-Budgetary | \$<br>358,606<br>183,306<br>1,922,711<br>1,298 | 834,282<br>311,324<br>1,348,884<br>(181,694) |
| Total  | \$<br>2,465,921                                | 2,312,796                                    |

Fund balances with Treasury are the aggregate amounts of the entity's accounts with Treasury for which TSA is authorized to make expenditures and pay liabilities. Other find types include Suspense Accounts, which temporarily hold collections pending clearance to the applicable account, and Deposit Funds, which are established to record amounts held temporarily until ownership is determined.

### (3) Property and Equipment, Net

Property and equipment balances as of September 30,2004 were as follows (dollars in thousands):

| Major classes   | Acquisition value                  | Accumulated depreciation | Net book<br>value            |
|---|------------------------------------|--------------------------|------------------------------|
| Equipment<br>Construction in progress<br>Leasehold improvements | \$<br>1,732,515<br>23,576<br>5,039 | (430,684)                | 1,301,831<br>23,576<br>5,039 |
| Total   | \$<br>1,761,130                    | (430,684)                | 1,330,446                    |

Property and equipment balances as of September 30,2003 were as follows (dollars in thousands):

| Major classes                         |     | Acquisition value    | Accumulated depreciation | Net book<br>value    |
|---------------------------------------|-----|----------------------|--------------------------|----------------------|
| Equipment<br>Construction in progress | \$_ | 1,449,114<br>126,236 | (169,375)                | 1,279,739<br>126,236 |
| Total                                 | \$  | 1,575,350            | (169,375)                | 1,405,975            |

Notes to Financial Statements September 30,2004

#### (4) Accounts Receivable, Net

Accounts receivable balances as of September 30,2004 and 2003 were as follows (dollars in thousands):

|   |          | 2004                | 2003               |
|---|----------|---------------------|--------------------|
| Intragovernmental: Accounts receivable Allowance for uncollectible accounts | \$       | 1,856 \$            | 130,545            |
| Total intragovernment receivables   |          | 1,856               | 130,545            |
| With the public: Accounts receivable Allowance for uncollectible accounts   | <u> </u> | 188,954<br>(38,854) | 20,741<br>(17,332) |
|   |          | 150,100             | 3,409              |
| Total accounts receivable, net  | \$       | 151,956 \$          | 133,954            |

The Intragovernmental accounts receivable balance for FY 2004 shows a significant decline from FY 2003 due to billing and collecting in FY 2004, the majority of reimbursable agreements owed TSA.

Accounts receivable with Public for FY 2004 shows an increase from FY 2003 due to FY 2004 having twelve months of collection activity without stoppage. The FY 2003 amount is indicative of seven months reporting of which three months (June 1 – September 30, 2003) of collecting from the airlines was waived by Congress.

Accounts receivable with public includes custodial receivables of \$488,000. Allowance for Uncollectible Accounts includes \$236,000 related to the custodial receivable.

Notes to Financial Statements September 30,2004

### (5) Liabilities not Covered by Budgetary Resources

TSA's liabilities not covered by budgetary resources as of September 30, 2004 and 2003 were as follows (dollars in thousands):

|   | _  | 2004                               |         | 2003                       |
|---|----|------------------------------------|---------|----------------------------|
| Intragovernmental: Federal employee compensation act (FECA) Other employment related liability            | \$ | 57,190<br>1,849                    | \$<br>  | 9,914<br>4,463             |
|   |    | 59,039                             | 10. 10. | 14,377                     |
| Unfunded leave<br>Actuarial FECA liabilities<br>Other employment related liability<br>Custodial liability | _  | 91,444<br>458,465<br>33,839<br>718 |         | 87,919<br>39,849<br>26,250 |
| Total liabilities not covered by budgetary resources  |    | 643,505                            |         | 168,395                    |
| Total liabilities covered by budgetary resources  | _  | 1,144,255                          | _       | 688,359                    |
| Total liabilities   | \$ | 1,787,760                          | \$      | 856,754                    |

An unfunded liability is recorded for the actuarial cost of workers' compensation benefits to be reimbursed to the Department of Labor (DOL) pursuant to the Federal Employee's Compensation Act (FECA). DOL administers the Federal Employee's Compensation Fund. TSA's liability accrued as of September 30, 2004, includes workers' compensation benefits paid by DOL during the year ended September 30,2004.

Notes to Financial Statements September 30,2004

### (6) Other Liabilities

TSA's other liabilities as of September 30,2004 were as follows (dollars in thousands):

|  | _   | Noncurrent liabilities | Current<br>liabilities | Total                     |
|--|-----|------------------------|------------------------|---------------------------|
| Intragovernmental: Advances from others Federal employees compensation act Other employment related liability Other post employment benefits | \$  | 57, <u>190</u><br>—    | 29,912<br>             | 29,912<br>57,190<br>1,849 |
| and payables   | _   |                        | 891                    | 891                       |
| Total other intragovernmental liabilities  | -   | 57,190                 | 32,652                 | 89,842                    |
| With the public:<br>Custodial liability<br>Liability for deposit and clearing funds  | _   |                        | 718<br>9,978           | 718<br>9,978              |
| Total other liabilities with public  | \$_ |                        | 10,696                 | 10,696                    |

Notes to Financial Statements September 30,2004

TSA's other liabilities as of September 30,2003 were as follows (dollars in thousands):

|                                    | Noncurrent liabilities |  | Current liabilities | Total   |  |
|------------------------------------|------------------------|--|---------------------|---------|--|
| Intragovemmental:                  |                        |  |                     |         |  |
| Advances from others               | \$                     | <u> </u>                                 | 13,890              | 13,890  |  |
| Employer contributions and payroll |                        |  | 17.620              | 15.620  |  |
| taxes payable                      |                        | a la | 15,638              | 15,638  |  |
| Federal employees compensation act |                        | 9,914                                    |                     | 9,914   |  |
| Other employment related liability |                        | -  | 4,463               | 4,463   |  |
| Deposit fund                       | 700                    |  | 130                 | 130     |  |
| Total other intragovemmental       |                        |  |                     |         |  |
| liabilities                        |                        | 9,914                                    | 34,121              | 44,035  |  |
| With the public:                   |                        |  |                     |         |  |
| Advances from others               |                        |  | 431                 | 431     |  |
| Employer contributions and payroll |                        |  |                     |         |  |
| taxes payable                      |                        |  | 1,778               | 1,778   |  |
| Other employment related liability |                        |  | 26,250              | 26,250  |  |
| Custodial liability                |                        | -  | 3,162               | 3,162   |  |
| Deposit funds                      |                        |  | (2,629)             | (2,629) |  |
| Total other liabilities            |                        |  |                     |         |  |
| with public                        | \$                     |  | 28,992              | 28,992  |  |

### (7) Statement of Financing

Other resources or adjustments to net obligated resources that do not affect the net cost of operations on the statement of financing consists of the following (dollars in thousands):

| Transfers in/out                     | \$<br>(2,614) |
|--------------------------------------|---------------|
| Other budgetary financing sources    | 23,287        |
| Reconciliation between budgetary and |               |
| proprietary amounts                  | <br>216,710   |
|                                      | \$<br>237,383 |

Notes to Financial Statements

September 30,2004

The other components requiring or generating resources in future periods on the statement of financing consist of the following (dollars in thousands):

| Change in FECA liability            | \$<br>47,277  |
|-------------------------------------|---------------|
| Change in actuarial FECA liability  | 418,616       |
| Change in other unfunded employment |               |
| liability                           | <br>4,974     |
| Total                               | \$<br>470,867 |

The other components not requiring or generating resources on the statement of financing consist of the following (dollars in thousands):

| Other expenses not requiring budgetary resources Allowance for doubtful accounts | \$<br>15<br>38,624 |
|--|--------------------|
| Total  | \$<br>38,639       |

#### (8) Leases

TSA has a total of 574 occupancy agreements with the General Services Administration for space in airports or surrounding areas. In addition, TSA has two lease agreements with the Public for headquarter buildings.

### **Operating Leases:**

Future payments are due as follows (dollars in thousands):

| Fiscal year: |              |         |
|--------------|--------------|---------|
| 2005         | \$           | 71,841  |
| 2006         |              | 72,376  |
| 2007         |              | 61,933  |
| 2008         |              | 42,852  |
| 2009         |              | 34,290  |
| After 2009   | <u>20—00</u> | 124,047 |
| Total        | \$           | 407,339 |

### (9) Contingencies

There are several claims which may be asserted against TSA regarding contractual agreements. If asserted, the likelihood of an unfavorable outcome is reasonably possible, and the potential loss would be over \$10 million. However, the government anticipates a favorable outcome.

Notes to Financial Statements September 30,2004

During FY 2004, TSA entered into the following agreements:

- 1) Termination Agreement TSA agreed to make payments to a vendor upon early termination of the contract to cover the substantial initial investment in equipment that the vendor will incur under the contract. Upon payment of the termination amount, TSA would have the right to ownership of the equipment. The termination liability decreases over two years and is estimated at \$158 million for 2005 and \$89 million for 2006.
- 2) Letters of Intent for Modifications to Airport Facilities TSA entered into Letters of Intent with eight major airports in which TSA may reimburse the airports for 75% (estimated total of \$957 million) of the cost to modify the facilities for security purposes. These Letters of Intent would not obligate TSA until funds have been appropriated and obligated. In addition, each airport shall have title to any improvements to its facilities. During fiscal year 2004, \$213 million was appropriated and is available for payment to the airports upon submission to TSA of an invoice for the modification costs incurred. As of September 30, 2004, TSA received invoices or documentation for costs incurred and paid in a total of \$72 million related to these agreements.

|           |        |              |         | (Dollars in th | ousands)      |         |         |
|-----------|--------|--------------|---------|----------------|---------------|---------|---------|
| A         | irport | 2003         | 2004    | 2005           | 2006          | 2007    | 'Total  |
| Airport 1 |        | \$<br>29,000 | 29,000  | 29,000         | 72 <u>-12</u> | 212     | 87,000  |
| Airport 2 |        | 17,813       | 17,813  | 17,813         | 17,813        |         | 71,252  |
| Airport 3 |        |              | 34,812  | 34,812         | 34,812        | _       | 104,436 |
| Airport 4 |        | -            | 33,000  | 42,000         | 42,000        | 42,000  | 159,000 |
| Airport 5 |        | 1-0          | 55,000  | 67,156         | 67,156        | 67,156  | 256,468 |
| Airport 6 |        |              | 15,000  | 26,250         | 26,250        | 26,250  | 93,750  |
| Airport 7 |        | _            | 13,000  | 26,167         | 26,167        | 26,167  | 91,501  |
| Airport 8 |        | <br>_        | 15,000  | 26,250         | 26,250        | 26,250  | 93,750  |
|           | Totals | \$<br>46,813 | 212,625 | 269,448        | 240,448       | 187,823 | 957,157 |

The amounts requested under these letters of intent may differ significantly from the original estimates and, therefore, TSA could ultimately pay substantially more than originally estimated.

3) Contract options with vendors – TSA entered into contracts with options in FY 2004 that provide TSA with the unilateral right to purchase additional services and or equipment or to extend the contract terms. Exercising these rights would require the obligation of funds in future years.

Notes to Financial Statements September 30,2004

### (10) Accounts Payable for Grants and Letters of Intent

Accounts payable balances shown on the balance sheet include accounts payable for grants and letters of intent as follows (dollars in thousands):

----

|   | _  | 2004      | 2003    |
|---|----|-----------|---------|
| Intragovernmental accounts payable        | \$ | 35,198    | 58,960  |
| Grants and cooperative agreements payable |    | 210,441   |         |
| Letters of intent payable                 |    | 187,316   |         |
| Accounts payable with the public          |    | 569,836   | 537,234 |
|   | \$ | 1,002,791 | 596,194 |

#### (11) Transfer of the Federal Air Marshal Service

Congress authorized the transfer' of the Federal Air Marshal Service (FAMS) from TSA to U.S. Immigration and Customs Enforcement (ICE) effective October 1,2003. In conjunction with the transfer, a separate appropriation was established specifically for the FAMS. However, Congress did not authorize the transfer of FAMS \$21.8 million in unliquidated obligations that were outstanding as of September 30, 2003. As a result, these obligations are reported in TSA's Financial Statements until they are fully liquidated. As of September 30, 2004, there were \$16.8 million in FAMS expenses included in TSA's financial statements and the balance of the pending obligations as of September 30,2004 was \$5.0 million.

### (12) Future Funding Requirements

TSA's future funding requirements consist of accrued FECA compensation, fines payable to the U.S. Treasury, actuarial liabilities and accrued annual and compensatory leave. Future funded liabilities are reported on the balance sheet and on the statement of financing. However, the future funded liability amounts included in these financial statements are different. As of September 30, 2004, TSA reported \$644 million in future funding requirements on the balance sheet, as illustrated in note 5, and reported \$328 million in components requiring or generating resources in future periods on the statement of financing. The future funding requirement amounts reported on the balance sheet consists of the current year unfunded liabilities and the liabilities from prior years that have not been funded as of the reporting date. The future funding requirements reported on the Statement of Financing consist only of the current year unfunded liabilities. Also, the TSA does not include unfunded fines liabilities due to Treasury on the Statement of Financing. These liabilities are custodial in nature and are included on the statement of custodial activity.

### (13) Subsequent Event

On December 21,2004, a settlement for \$169 million was made for claims against TSA that stemmed from a FY 2002 lawsuit brought against the agency. This amount has been recorded as an expense for the year ended September 30,2004 and is reflected as a liability as of September 30, 2004.

Required Supplementary Stewardship Information September 30,2004

(Unaudited)

(Dollars in thousands)

|                              | 5 <u>1</u> | 2004    |
|------------------------------|------------|---------|
| Nonfederal property:         |            |         |
| Airport improvement property | \$         | 287,441 |
| Port security program        |            | 217,745 |
| Intercity bus program        | _          | 18,340  |
| Total                        | \$         | 523,526 |
| Human capital:               |            |         |
| Highway watch cooperative    | •          | 7 522   |
| arrangements                 | » —        | 7,532   |
| Total                        | \$         | 7,532   |
| Research and development:    |            |         |
| Applied research projects    | \$         | 30,138  |
| Operation safe commerce      |            | 50,236  |
| Total                        | \$         | 80,374  |

<sup>\*</sup> Investments in Nonfederal property, Human Capital and research and development are not presented for FY 2003 since amounts reported in the statement of net cost are not presented on a comparative basis.

### **Stewardship Investments**

Stewardship investments are the costs incurred by the Federal Government for the benefit of the United States. These investments represent federally financed (but not federally owned) purchases, construction, or major renovations of physical property owned by state and local governments, including major additions, alterations, replacements, and the purchase of major equipment; and the purchase or improvement of other physical assets. Though the cost is treated as expenses to determine TSA's net cost of operations, these items merit special treatment so that users of Federal financial reports know the extent of investments that are made for the long-term benefit of the United States.

During fiscal year 2004, the grant award functions of the TSA Maritime and Land Security programs was transferred to the DHS Secretary's new Office of State and Local Government Coordination and Preparedness (SLGCP). The transfer is to be accomplished in two phases. In the first phase, all program development and program management functions associated with the programs transitioning from TSA will be integrated with existing Office of Domestic Preparedness program development and program management operations. The staffers associated with those functions were detailed to SLGCP, with permanent transfer at the end of fiscal year 2004. However, the financial management functions for all grants issued prior to fiscal year 2005 will stay with TSA.

Required Supplementary Stewardship Information
September 30,2004
(Unaudited)
(Dollars in thousands)

#### **Investments in Nonfederal Property**

Airport Improvement Program – TSA purchases and installs in-line explosive detection systems (EDS) equipment through a variety of funding mechanisms, including Congressionally authorized Letters of Intent (LOIs). LOIs provide partial reimbursement to airports for facility modifications required to install in-line EDS solutions. TSA has issued eight LOIs for nine airports to provide for the facility modifications necessary to accommodate in-line EDS screening solutions at these airports.

In-line systems also allow TSA to achieve maximum baggage throughput capacity. For example, a stand-alone EDS system can screen 180 bags per hour, while an in-line unit can screen 450 bags per hour. An added benefit is that installation of an in-line EDS system removes checked baggage screening operations from the airport lobby. However, in-line EDS systems are considerably more costly than stand-alone EDS and many airports are not configured to accommodate installation of EDS technology in-line without extensive facility modifications. These funds are available only for physical modification of commercial service airports for the purpose of installing checked baggage explosive detection systems.

*Port Security Grant Program* – This program provided grants to critical national seaports to support the security efforts at the port through enhanced facility and operational security. These grants contribute to important security upgrades such as surveillance equipment, access controls to restricted areas, communications equipment, and the construction of new command and control facilities.

*Intercity Bus Security Program* – This program provides funds to improve security for intercity bus operators and passengers. TSA awards grants based on the following program categories:

- Vehicle specific security enhancements to protect or isolate the driver, alarms, security mirrors, etc.
- Monitoring, tracking, and communication technologies for over-the-road buses.
- Implementation and operation of passenger and baggage screening programs at terminals and over-the road buses.
- Development of an effective security assessmentlsecurity plan that identifies critical security needs and vulnerabilities.
- Training for drivers, dispatchers, ticket agents, and other personnel in recognizing and responding to criminal attacks and terrorist threats, evacuation procedures, passenger screening procedures, and baggage inspection.
- Facility security enhancements (alteration/renovation) to terminals, garages and facilities, including but not limited to: fencing, lighting, secured access, locking down of vehicles, and securing of bus yardsldepots,

### **Investments in Human Capital**

Highway Watch Cooperative Agreement – This cooperative agreement between TSA and the American Trucking Associations (ATA) expands ATA's Highway Watch program, which educates highway professionals to identify and report safety and security situations on our Nation's roads. The program will provide training and

Required Supplementary Stewardship Information
September 30,2004
(Unaudited)
(Dollars in thousands)

communications infrastructure to prepare 400,000 transportation professionals to respond in the event they or their cargo are the target of a terrorist attack and to share valuable intelligence with TSA if they witness potential threats. The intelligence will allow Federal agencies and industry stakeholders to quickly move to prevent an attack or to immediately respond if an attack occurs.

#### **Investments in Research and Development**

Applied Research Projects – TSA funds applied research projects and grants to develop advance security technology equipment and systems. Projects include partnerships with George Mason University, the Regional Maritime Security Coalition, and the Federal Aviation Administration. These applied research projects include human factors research intended to enhance screener capabilities, improve person-machine performance, and increase human system effectiveness; ongoing certification testing of EDS and ETD technology; and infrastructure protection research related to using biometrics for passenger access controls and tracking.

Operation Safe Commerce – Operation Safe Commerce is a pilot program that brings together private business, ports, local, state, and federal representatives to analyze current security procedures for cargo entering the country. The ports of Seattle and Tacoma, Los Angeles and Long Beach, and the Port Authority of New York/New Jersey are participating in the pilot program. The program will function like a venture capital fund to utilize existing technology to monitor the movement and integrity of containers through the supply chain. Selected ports will test new technologies and initiatives in selected supply chains. The new technologies will look at improving security during the process of stuffing and deconsolidating containers, physically securing and monitoring containers as they are transported through the supply chain, and exchanging timely and reliable communication.

Required Supplementary Information

Intragovernmental Assets

September 30,2004

(Unaudited)

(Dollars in thousands)

| Partner agency code and name   |     | Due from the<br>General Fund | Accounts receivable | Advances and prepayments |
|--|-----|------------------------------|---------------------|--------------------------|
| <ul><li>20 Department of Treasury</li><li>69 Department of Transportation</li><li>70 Department of Homeland Security</li></ul> | \$  | 2,465,921<br>—<br>—          |                     |                          |
| Totals   | \$_ | 2,465,921                    | 1,856               | <u> </u>                 |

Intragovernmental Assets
September 30,2003
(Unaudited)

(Dollars in thousands)

| Partner agency code and name       |    | Due from the<br>General Fund | Accounts receivable | Advances and prepayments |
|------------------------------------|----|------------------------------|---------------------|--------------------------|
| 20 Department of Treasury          | \$ | 2,312,796                    | 1 <del></del>       |                          |
| 17 Department of the Navy          |    | 85), Ø                       | 378                 |                          |
| 19 Department of State             |    | _                            | 1,000               |                          |
| 69 Department of Transportation    |    |                              | 34,314              | 3,636                    |
| 70 Department of Homeland Security | _  |                              | 94,853              | <u> </u>                 |
| Totals                             | \$ | 2,312,796                    | 130,545             | 3,636                    |

See accompanying independent auditors' report.

Required Supplementary Infonnation

Intragovernmental Liabilities

September 30,2004

(Unaudited)

(Dollars in thousands)

| Partner agency code and name               | Accounts payable | FECA   | Advances from others and other liabilities |
|--|------------------|--------|--|
| 04 Government Printing Office              | \$<br>470        |        | -  |
| 14 Department of Interior                  | 36               |        |  |
| 15 Department of Justice                   | 129              | -      |  |
| 16 Department of Labor                     | -                | 57,190 |  |
| 17 Department of the Navy                  | 1,491            |        |  |
| 19 Department of State                     | 1,435            |        |  |
| 20 Department of Treasury                  | 76               |        | 1 <del></del> 1                            |
| 21 Department of the Anny                  | 4,135            |        |  |
| 24 OPM                                     | 2,496            |        | 2,740                                      |
| 47 General Services Administration         | 3,908            |        | _  |
| 49 National Science Foundation             | 36               |        |  |
| 57 Department of the Air Force             | 4,879            |        |  |
| 69 Department of Transportation            | 10,144           | 100    | 29,912                                     |
| 70 Department of Homeland Security         | 312              | _      | -  |
| 75 Department of Health & Human Services   | 711              |        |  |
| 88 National Archives and Records Admin.    | 1                |        | ~-   |
| 89 Department of Energy                    | 1,078            |        |  |
| 96 US Army Corps of Engineers              | 1,347            |        |  |
| 97 Office of the Secretary of Defense – DA | <br>2,514        |        |  |
| Totals                                     | \$<br>35,198     | 57,190 | 32,652                                     |

### Intragovernmental Liabilities

September 30, 2003

(Unaudited)

(Dollars in thousands)

|    | Accounts payable | FECA        | Advances from others and other liabilities  |
|----|------------------|-------------|---|
| \$ |                  |             | 130   |
|    | 19               | _           |   |
|    |                  | 9,914       | _   |
|    | _                | _           | 15,638  |
|    | 7,017            | ·           | 4,463   |
|    | 5,358            | _           | <u> </u>  |
|    | 44,216           | ·           | 13,890  |
|    | 1,050            |             |   |
| _  | 1,300            |             | <del></del> ,   |
| \$ | 58,960           | 9,914       | 34,121  |
|    | \$<br>\$<br>\$   | payable  \$ | payable         FECA           \$         —         —           19         —         9,914           —         —         —           7,017         —         —           5,358         —         —           44,216         —         —           1,050         1,300         — |

See accoinpanying independent auditors' report.

Required Supplementary Information

Intra-governmental Earned Revenue, Other Financing Sources, and Transfers

Year ended September 30,2004

(Unaudited)

(Dollars in thousands)

| Partner agency code and name       |    | Earned<br>revenue | Imputed<br>financing<br>sources | Transfers<br>in/(out) |  |
|------------------------------------|----|-------------------|---------------------------------|-----------------------|--|
| 00 Unknown                         | \$ | 16                | _                               |                       |  |
| 17 Department of the Navy          |    | 2,408             |                                 | _                     |  |
| 24 OPM                             |    |                   | 209,881                         |                       |  |
| 69 Department of Transportation    |    | 92,797            |                                 | _                     |  |
| 70 Department of Homeland Security |    | 59,549            |                                 | (2,614)               |  |
| Totals                             | \$ | 154,770           | 209,881                         | (2,614)               |  |

See accompanying independent auditors' report.

Required Supplementary Information

Intragovernmental Costs

Year ended September 30,2004

(Unaudited)

(Dollars in thousands)

## Partner agency

| code and name                              |     | Costs   |
|--|-----|---------|
| 00 Unknown                                 | \$  | 20,105  |
| 04 Government Printing Office              |     | 698     |
| 12 Department of Agriculture               |     | 2,841   |
| 13 Department of Commerce                  |     | 105     |
| 14 Department of Interior                  |     | 5,184   |
| 15 Department of Justice                   |     | 10,247  |
| 16 Department of Labor                     |     | 48,168  |
| 17 Department of the Navy                  |     | 9,531   |
| 18 U.S. Postal Service                     |     | 10      |
| 19 Department of State                     |     | 1,435   |
| 20 Department of Treasury                  |     | 1,942   |
| 21 Department of the Army                  |     | 9,086   |
| 24 OPM                                     |     | 215,780 |
| 45 EEOC                                    |     | _38     |
| 47 General Services Administration         |     | 119,729 |
| 49 National Science Foundation             |     | 39      |
| 57 Department of the Air Force             |     | 7,228   |
| 69 Department of Transportation            |     | 104,048 |
| 70 Department of Homeland Security         |     | 9,349   |
| 75 Department of Health and Human Services |     | 2,043   |
| 88 National Archives and Records Admin.    |     | 1       |
| 89 Department of Energy                    |     | 2,368   |
| 99 US Army Corps of Engineers              |     | 11,578  |
| 97 Office of the Secretary of Defense – DA | _   | 5,270   |
| Totals                                     | \$_ | 586,823 |

See accompanying independent auditors' report.

### Other Accompanying Information

### Consolidated Statement of Net Cost by Program and Strategic Goals

### Year ended September 30,2004

(Dollars in thousands)

| Program Aviation Security:   Program Aviation Security:   Gross cost - intragovernmental   | Strategic goals  |            | Total     | Awareness | Prevention | Protection | Response | Excellence |
|--|--|------------|-----------|-----------|------------|------------|----------|------------|
| Second contemental   Second contemental   Second contemplate   Second  |  |            | 100%      | 4%        | 65%        | 27%        | 1%       | 3%         |
| Net cost of services provided to federal agencies   14,965,743   198,631   3,227,732   1,340,749   595,182   20,710   62,131   | Gross cost – intragovemmental                                    | \$         |           |           |            |            |          |            |
| Case   Secure   Sec | Net cost of services provided to federal agencies                | <u></u>    | 209,649   | 8,386     | 136,272    | 56,606     | 2,096    | 6,289      |
| Net cost of services provided to the public   Sample    | Gross cost – with the public Less revenue earned from the public | <u>.</u>   |           |           |            |            |          | 62,131     |
| Program Martime and Land Security:   Gross cost - intragovernmental  | Net cost of services provided to the public                      | _          | 2,894,699 | 115,789   | 1,881,553  | 781,567    | 28,948   |            |
| Cross cost - intragovernmental   S   10,376   415   6,744   2,802   104   311  | Net cost   | <b>s</b> _ | 3,104,348 | 124,175   | 2,017,825  | 838,173    | 31,044   | 93,131     |
| Net cost of services provided to federal agencies   167,613   6,704   108,949   45,256   1,676   5,028   | Gross cost – intragovernmental                                   | s          | 10,376    |           | 6,744      | 2,802      |          |            |
| Class revenue earned from the public   167,613   6,704   108,949   45,256   1,676   5,028     Net cost of services provided to the public   167,613   6,704   108,949   45,256   1,676   5,028     Net cost   177,989   7,119   115,693   48,058   1,780   5,339     Program Intelligence:   | Net cost of services provided to federal agencies                | <u></u>    | 10,376    | 415       | 6,744      | 2,802      | 104      | 311        |
| Net cost of services provided to the public   S   177,989   7,119   115,693   48,058   1,780   5,339   |  |            | 167,613   | 6,704     | 108,949    | 45,256     | 1,676    | 5,028      |
| Program Intelligence:         S         140         6         91         38         1         4           Corss cost - intragovernmental         140         6         91         38         1         4           Less revenue earned from federal agencies         140         6         91         38         1         4           Gross cost - with the public         9,433         377         6,132         2,547         94         283           Less revenue earned from the public         9,433         377         6,132         2,547         94         283           Net cost of services provided to the public         9,433         377         6,132         2,547         94         283           Net cost of services provided to the public         9,573         383         6,223         2,585         95         287           Program Research and Development:         9,573         149         2,421         1,006         37         112           Gross cost - intragovernmental         \$ 3,725         149         2,421         1,006         37         112           Less revenue carned from federal agencies         3,725         149         2,421         1,006         37         112           Gross cost - wit  | Net cost of services provided to the public                      | <u>20-</u> | 167,613   | 6,704     | 108,949    | 45,256     |          |            |
| Company   Comp | Net cost   | \$ _       | 177,989   | 7,119     | 115,693    | 48,058     | 1,780    | 5,339      |
| Company   Comp | Gross cost - intragovernmental                                   | \$         | 140       | 6         |            | 38         | 100      |            |
| Comparison Research and Development:   Comparison Research and Development:   Section 1.006   Services provided to federal agencies   Services provided to federal a | Net cost of services provided to federal agencies                | _          | 140       | 6         | 91         | 38         | 1_       | 4_         |
| Net cost of services provided to the public   S   9,573   383   6,223   2,585   95   287   |  | <u></u>    | 9,433     |           |            | 2,547      |          |            |
| Program Research and Development:   Gross cost - intragovernmental   | Net cost of services provided to the public                      | <u>_</u>   | 9,433     | 377       | 6,132      | 2,547      |          |            |
| Second = intragovernmental   \$ 3,725   149   2,421   1,006   37   112   | Net cost   | \$ _       | 9,573     | 383       | 6,223      | 2,585      | 95       | 287        |
| Gross cost – with the public Less revenue earned from the public Net cost of services provided to the public  Net cost of services provided to the public  October 18,132 671 2,014  18,132 671 2,014  18,132 671 2,014  | Gross cost – intragovernmental                                   | \$         | 3,725     | 149       |            | 1,006      |          |            |
| Less revenue earned from the public  | Net cost of services provided to federal agencies                | <u> 22</u> | 3,725     | 149       | 2,421      | 1,006      | 37       | 112        |
| Net cost of services provided to the public 2,355 46,072 10,128 708 2,126  |  |            |           | 2,686     | 43,652     | 18,132     |          |            |
| Net cost \$ 70,880 2,835 46,073 19,138 708 2,126   | Net cost of services provided to the public                      | <u>~</u>   | 67,155    | 2,686     | 43,652     | 18,132     |          |            |
|  | Net cost   | s _        | 70,880    | 2,835     | 46,073     | 19,138     | 708      | 2,126      |

(Continued)

Other Accompanying Information

Consolidated Statement of Net Cost by Program and Strategic Goals

Year ended September 30,2004

(Dollars in thousands)

| Strategic goals Strategic goals   |         | Total                  | Awareness         | Prevention             | Protection           | Response         | Excellence        |
|---|---------|------------------------|-------------------|------------------------|----------------------|------------------|-------------------|
| Program Administration: Gross cost – intragovemmental Less revenue earned from federal agencies | \$_     | 231,472<br>23,308      | 9,259<br>932      | 150,457<br>15,151      | 62,497<br>6,293      | 2,315<br>233     | 6,944<br>699      |
| Net cost of services provided to federal agencies   | _       | 208,164                | 8,327             | 135,306                | 56,204               | 2,082            | 6,245             |
| Gross cost – with the public Less revenue earned from the public                                | _       | 340,222<br>7           | 13,608            | 221,146<br>5           | 91,860<br>2          | 3,402            | 10,206<br>—       |
| Net cost of services provided to the public   | _       | 340,215                | 13,608            | 221,141                | 91,858               | 3,402            | 10,206            |
| Net cost  | \$_     | 548,379                | 21,935            | 356,447                | 148,062              | 5,484            | 16,451            |
| Total TSA: Gross cost – intragovemmental Less revenue earned from federal agencies              | s       | 586,823<br>154,769     | 23,473<br>6,190   | 381,435<br>100,601     | 158,443<br>41,787    | 5,868<br>1,548   | 17,604<br>4,643   |
| Net cost of services provided to federal agencies   | <u></u> | 432,054                | 17,283            | 280,834                | 116,656              | 4,320            | 12,961            |
| Gross cost – with the public  Less revenue earned from the public                               | _       | 5,550,166<br>2,071,052 | 222,006<br>82,842 | 3,607,611<br>1,346,184 | 1,498,544<br>559,184 | 55,501<br>20,711 | 166,504<br>62,131 |
| Net cost of services provided to the public   | -       | 3,479,114              | 139,164           | 2,261,427              | 939,360              | 34,790           | 104,373           |
| Net cost  | s _     | 3,911,168              | 156,447           | 2,542,261              | 1,056,016            | 39,110           | 117,334           |

See accompanying independent auditors' report

U.S. Department of **Homeland** Security **Arlington**, Virginia 22202-4220



### APR 1 1 2005

MEMORANDUM FOR: Richard L. Skinner

**Acting Inspector General** 

THROUGH: Randy Beardsworth

**Acting Under Secretary** 

Border and Transportation Security

FROM: David M. Stone

Assistant Secretary

SUBJECT: Draft Report: Independent Auditors' Report on TSA's FY 2004

Financial Statements

We completed our review of the draft *Independent Auditors' Report on TSA's FY 2004*Financial Statements. The audit firm of KPMG LLP performed a full-scope audit on TSA's consolidated balance sheet and related statements of net cost, changes in net position, budgetary resources, financing, and accompanying notes for which an unqualified, or clean, audit opinion was issued. We concur with the report, as presented, in its entirety.

During the course of the audit, KPMG LLP identified and provided recommendations for three material weaknesses: (1) Financial Systems Information Technology; (2) Internal Control Monitoring and Evaluation; and (3) Grants Management.

Actions we are taking on these material weaknesses are outlined below:

- Financial Systems Information Technology. We will continue our current process
  of manual controls, reconciliation, and weekly meetings until assurance is available
  that financial system controls are completely effective. Control procedures will
  continue to be documented and records will be maintained to ensure that required
  data reconciliations are performed.
- 2. Internal Control Monitoring and Evaluation. We have published a Management Control Directive and are implementing an agency-wide internal/management control program to ensure compliance with the Federal Managers' Financial Integrity Act (FMFIA). The program is based on the Government Accountability Office (GAO) standards for internal/management control and encompasses our entire organization. We are instructing TSA managers on their FMFIA responsibilities and providing training on assessing mission risks and implementing management controls. TSA mission area managers will provide input into the annual Statement of Assurance required by the FMFIA.

### MANAGEMENT'S RESPONSE TO THE INDEPENDENT AUDITOR'S REPORT

3. Grants Management. We have obtained the missing performance reports, payment approvals, and application packages noted in the audit. We have issued instructions to verify the accuracy of tax identification numbers. As certain grants management functions are transitioned to the DHS Office of State and Local Government Coordination and Preparedness, we are ensuring application packages are properly maintained, performance reports are obtained, and requirements of the Office of Management and Budget (OMB) Circular A-133 are met.

The FY 2005 Financial Statement Audit began with the entrance conference on March 2, 2005. TSA will again receive a full scope, stand-alone audit. It is our goal to earn an unqualified audit opinion, as we have every year since TSA's inception.

I wish to take this opportunity to thank the Office of the Inspector General for taking the time to review, edit, and issue TSA's FY 2004 Financial Statements.

If you have additional questions, please contact Mr. Jeffrey Bobich, Deputy Director, Office of Financial Management on 571-227-2118.

### **Department of Homeland Security**

Secretary
Deputy Secretary
Executive Secretariat
Chief of Staff
General Counsel
Under Secretary, Border and Transportation Security
Under Secretary, Management
Chief Financial Officer
Chief Information Officer
Assistant Secretary for Public Affairs
Chief Security Officer
OIG Liaison

## **Transportation Security Administration**

Assistant Secretary for Transportation Security Administration Chief Financial Officer Chief Information Officer

### Office of nt and d

Chief, Homeland Security Branch DHS OIG Program Examiner

### Congress

Committee on Homeland Security and Governmental Affairs United States Senate

Committee on Homeland Security United States House of Representatives



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